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TAGS: [EFIN](#) [EREL](#) [ETRD](#) [PGOV](#) [PINR](#) [UP](#) [XH](#)
SUBJECT: IMF AT ANOTHER UKRAINE IMPASSE

REF: A. KYIV 1835
[1](#)B. KYIV 1760

Classified By: CDA James Pettit for Reasons 1.4 (b) and (d)

[1](#)1. (C) Summary. Negotiations between the IMF and Ukrainian authorities appear to have stalled over a bloated budget and the uncertain fate of a new social spending law which, if signed by the President, would represent a "red line" for the Fund. According to the IMF's Kyiv-based resident representative Max Alier, who briefed G-7 ambassadors on October 27, IMF mission head Ceyla Pazarbasioglu departed from Kyiv without reaching agreement on terms for disbursing the fourth tranche.

[1](#)2. (C) Alier noted that the political situation was "difficult" and the IMF and senior Ukrainian officials were "still negotiating". President Yushchenko had thus far declined to sign a letter of intent (LOI) regarding conditions for a fourth tranche, with NBU leadership also withholding support. Although PM Tymoshenko had signaled she was prepared to sign the LOI, she had not reached an agreement with the IMF on problems with the draft 2010 budget. End summary.

SOCIAL BENEFITS LAW IS "RED LINE"

[1](#)3. (C) According to Alier, the IMF is most concerned about the "social benefits" law adopted by the Rada (Ukraine's parliament) on October 20 (Ref A). President Yushchenko thus far had not signaled his intentions on whether he would sign the law. He apparently had failed to respond to a meeting request from IMF envoy Pazarbasioglu after the law's passage, although Pazarbasioglu waited two days for the appointment.

[1](#)4. (C) Meanwhile, the IMF had strongly pushed for a veto with representatives from the Presidential Secretariat, who have given indications that they would oppose the law. Alier told G-7 ambassadors that he would meet with Deputy Head of the Presidential Secretariat Oleksandr Shlapak on October 27 to again press for a veto. (Note: The deadline for a Presidential veto is on/around November 5).

[1](#)5. (C) In the Fund's estimation, Yushchenko allegedly "does not see the purpose" of a LOI with the presidential election looming and politics dominating economic policy making. Although staff from the Finance Ministry and National Bank of Ukraine (NBU) had a good understanding of what needs to be done to maintain the loan program, the IMF mission was puzzled by the President's actions and could not determine whether he understood the full extent of Ukraine's economic problems.

¶16. (C) Alier argued that while the Fund had required fiscal discipline for neighboring countries, notably Hungary, it had previously taken a more lenient position with Kyiv authorities, allowing for the effects of Ukraine's significant 2009 GDP decline. In particular, the IMF already had shown significant flexibility by allowing wage and pension increases to occur in line with inflation. But the new social benefits law represented a "red line" that required a Presidential veto. According to Alier, if the IMF were to "cave" on the social benefits law, then "everything would go."

FLABBERGASTED OVER THE BUDGET(S)

¶17. (C) Even if the social benefits law were to be vetoed, Alier stated the 2009 fiscal situation was very tight. He projected that the GOU would run out of money within three weeks if the IMF did not disburse its fourth tranche. Revenues were collapsing, as tax payers had lost confidence in the authorities. Alier surmised that "if you don't give (VAT) refunds, they don't pay taxes," and sizeable wage and pension arrears would become the order of the day. Alier noted the "car was already sputtering" and that transfer payments to local budgets already had been delayed.

¶18. (C) The IMF was "flabbergasted" at the draft 2010 budget that the Cabinet of Ministers had submitted to the Rada. With a projected 8% of GDP deficit, the draft 2010 budget was "in contempt" of the IMF program. Alier noted that Tymoshenko had tried to reassure the IMF mission, reasoning that the draft 2010 budget would not pass the Rada in any

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case, and that submitting a more austere budget would damage her politically prior to the election.

¶19. (C) There had been an internal debate within the IMF mission as to whether it would require Tymoshenko to resubmit the draft 2010 budget (which the Prime Minister has refused to do thus far), or whether the GOU could commit itself to cut the budget by administrative means. Alier indicated that resubmission of the budget would be a complicated process. Moreover, under Ukrainian law and regulations, resubmitting the budget would not be technically possible until the latter part of November at the earliest.

A LONELY FRIEND

¶110. (C) With the World Bank and EBRD saying "goodbye" to the GOU until further reforms had been made, IMF management was uncomfortable that the Fund was the "only game in town". Alier observed that the IMF now found itself in a "no-win" situation: either it would disburse the fourth tranche and be accused of "choosing a candidate," or it would not disburse and "see the country go up in flames." Alier added that he had worked as an IMF official in other crisis situations (such as Argentina, Brazil, and Indonesia), but that Ukraine's political situation was "as dysfunctional as it gets, with politicians willing to bring down the entire country in order to bring each other down."

¶111. (C) Alier dismissed oft-repeated Party of Regions' claims that the IMF had endorsed Tymoshenko's candidacy via its loan program, arguing that Ukraine's economic situation was such that whoever won the presidential election would be calling the IMF the next day.

NUMBERS UNDETERMINED

¶112. (C) Alier could not say whether the IMF, if it chose to release a fourth tranche, would support disbursement of the full \$3.8 billion as scheduled. If the GOU had been in compliance with prior actions and structural benchmarks, then

full disbursement would be in order. The IMF official cautioned that if implementation of conditionalities was "backloaded", then disbursements logically would be backloaded as well, though the IMF had no mechanism for spreading out the disbursement of a particular tranche in steps/stages.

¶13. (C) The IMF had considered it might "recalibrate" and disburse a lesser amount than what had been previously scheduled. In any case, if it were to disburse, the IMF would want monies directed to the NBU, which in turn could transfer funds to the GOU. Alier acknowledged that difficult relations between the NBU and GOU complicated such a scheme (Ref B).

GAS PAYMENTS AND PRICES

¶14. (C) On gas payments to Russia, Alier estimated that \$400 million would come due on November 6, while Ukraine would need to transfer just short of \$1 billion on December 6. Alier maintained that Ukraine's foreign reserves of \$26 billion were more than sufficient to meet monthly gas obligations. But an ongoing "stupid family argument" could scuttle plans for the NBU to monetize GOU treasury bills for gas payments (Ref B). In any event, it would be impossible for the IMF to disburse before November 6.

¶15. (C) Alier displayed considerable skepticism about the GOU's stated rationale for not implementing previously promised gas price increases. Labor unions (currently picketing the IMF's Kyiv offices) never before had garnered a role in such decisions, he said. Alier expressed similar doubt about municipalities' reluctance to increase gas prices for utilities.

¶16. (C) The IMF official noted that if it came to it, he could see the Ukrainians "closing the tap" on gas imports this winter. In the event the country was unable to make payments to Gazprom, it would consider using its sufficient reserves in storage for domestic consumption during the winter heating season. Alier said he expected Russian officials would pressure the IMF on disbursement of the next tranche, as Russia wanted to ensure that revenues from

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Ukrainian gas purchases would continue.

NEXT STEPS

¶17. (C) Alier indicated that the IMF team had returned to Washington and, at present, saw no reason to come back to Ukraine. The Fund was working on a communications strategy, recognizing that if it does not disburse the fourth tranche, then severe economic consequences for Ukraine could follow. Alier underscored the possibility of significant hryvnia depreciation and another round of destabilization in the banking system.

¶18. (C) Alier indicated the situation had moved past his technical, civil servant status, and was now a political issue for more senior officials. He invited capitals to provide policy input.

COMMENT

¶19. (C) One diplomatic colleague likened Ukraine's current situation to "being in a hole and digging," with the President now wielding the spade. On its merits, Yushchenko -- who has made it a point to speak out against populist public spending -- should veto the bill. However, Yushchenko's desire to harm Tymoshenko could, as it has so often in the past, get the better of him. It is notable that the remnant in the Rada that still backs Yushchenko voted in

favor of the bill)- along with Yanukovych, the Communists and Speaker Lytvyn,s bloc -- and against Tymoshenko.

¶20. (C) Ukraine's pit could grow deeper soon. Information about the IMF's self-described "no-win" situation has yet to hit the market, and analysts are still predicting that the Fund will disburse the entire tranche as soon as the social benefits law is vetoed. A leak about the program's indefinite delay and ultimate recalibration may have an immediate impact on the exchange rate, with knock-on effects for the banking sector.

¶21. (C) While dramatic, this situation resembles the scenario after the first formal review, when the Fund walked out for a lengthy period, only to return with a display of heightened flexibility. A key difference now may be that the Fund no longer has room to give on the budget. Additionally, with the election looming, it must carefully tread among critics who claim it has unduly favored a particular presidential candidate.

PETTIT